

# Communication of Financial Results “Opening the Black Box”

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## Topics

- Who are the audiences?
- What is communicated?
- What are some communication hurdles?
- How we communicate?
- CFO expectations?
- What are the results of effective communication at Premera?

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## Audiences / Timing

- CFO - monthly
- Market Leads - monthly
- Underwriting / Sales / Product - monthly
- Operations - monthly
- Board of Directors - quarterly
- Rating Agencies - annual
- Auditors – annual

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## CFO and Senior Management

- Monthly communication on changes in liabilities
- Breakdown of changes in assumptions used in setting liabilities
- Quarterly financial outlook and potential risks / upsides
- Changes in trends

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## Market Leads

- Monthly meetings of financial results
- Communication on pricing changes
- Communication of product strategies
- Ongoing hallway conversations

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## Underwriting / Sales / Product Development

- Team effort to set strategies and tactics to achieve profit objectives
- Monthly review of underwriting business decisions
- Communication of trends
- Communication of pricing
- Membership and underwriting results by plan design

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## Operations

- Monthly communication to determine potential pitfalls in setting monthly liabilities
- Communication to explain how their work impacts financial reporting and pricing

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## Board of Directors

- Quarterly communication: Income Statement, Balance Sheet, and detail of changes in claim liabilities
- Communication of potential financial risks

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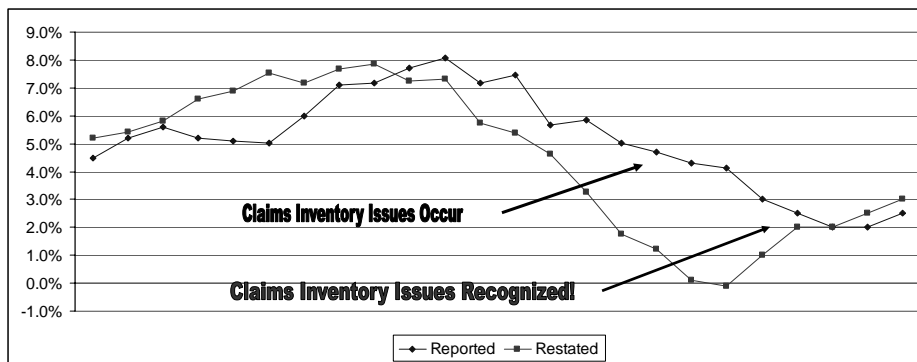
## Rating Agencies

- Annual communication of financial results, pricing decisions, and forecasts with S&P and AM Best

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## Communication Hurdles

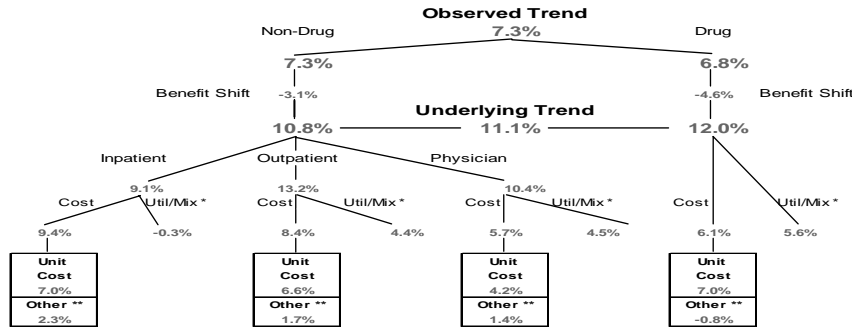
- Explaining Reported Financials vs Restated Financials – Operating Income Ratio
  - Restated are used in setting premiums
  - Need to communicate differences with Market Leads



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## Communication Hurdles

- Explaining Trend – Differences between Observed and Underlying



\* Util/Mix includes Aging Health Status, Deductible Leveraging, Consumer Demand, Service Intensity, Pharmacy Management Program, New Drug & Off Patent Impact, Care Facilitation, Government Mandate, & Business Mix  
 \*\* Other includes Service Intensity, Government Mandate & Business Mix

## Communication Hurdles

- Pricing – Balancing Membership Growth with profit
- Explaining IBNR changes, Provision for Adverse Deviation

## Methods of Communication

- Support of Provision for Adverse Deviation Level
  - More x's → More Risk → More Required PAD

LOB	Type	System Conversion	Claims Inventory Backlog	Product Portfolio Changes	Membership Changes	Size - Statistical Credibility	Additional Risk for Adverse Events	System Slow Down	PAD
LOB #1	Fully Insured				x		x		9.0%
LOB #2	Fully Insured	x		x			x		11.0%
LOB #3	Fully Insured						x		8.0%
LOB #4	Fully Insured				x		x		9.0%
LOB #5	Fully Insured						x		8.0%
LOB #6	ASC								0.0%
LOB #7	Fully Insured			x	x		x		11.0%
LOB #8	Fully Insured			x		x	x		11.0%
LOB #9	Fully Insured		x	x		x	x		14.0%
LOB #10	ASC								0.0%
LOB #11	Fully Insured				x		x		9.0%
Total Exclude ASC									10.0%
Total									8.2%

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## Methods of Communication

- Trend Model – Breakdown of Major components used to project trend

		PROJECTED Trend				
		2006	2007	2008	2009	2010
<b>Medical</b>						
<i>Inpatient Hospital</i>	Unit Cost	6.3%	7.9%	6.7%	6.1%	6.1%
	Service Intensity	1.9%	2.1%	2.1%	2.1%	2.1%
	Govt Mandate	0.1%	0.1%	0.0%	0.0%	0.4%
	Business Mx	0.1%	0.1%	0.4%	0.6%	0.4%
	Other	0.0%	0.0%	0.0%	0.0%	0.0%
	<b>Total Cost</b>	<b>8.6%</b>	<b>10.4%</b>	<b>9.5%</b>	<b>9.0%</b>	<b>9.2%</b>
	Aging/Health Status	1.3%	1.4%	1.4%	1.4%	1.4%
	Service Intensity	0.0%	0.0%	0.0%	0.0%	0.0%
	Consumer Demand	2.2%	1.9%	1.5%	1.8%	1.9%
	Ded. Leveraging	1.2%	1.2%	1.1%	1.1%	1.1%
	Care Facilitation	-3.8%	-4.7%	-1.9%	-0.9%	-0.9%
	Govt Mandate	0.1%	0.1%	0.0%	0.0%	0.4%
	Business Mx	0.0%	0.0%	0.0%	0.1%	0.1%
	Other	0.0%	0.0%	0.0%	0.0%	0.0%
	Total Utilization	1.0%	-0.3%	2.0%	3.6%	4.1%
	<b>Total Inpatient</b>	<b>9.7%</b>	<b>10.1%</b>	<b>11.7%</b>	<b>12.9%</b>	<b>13.7%</b>

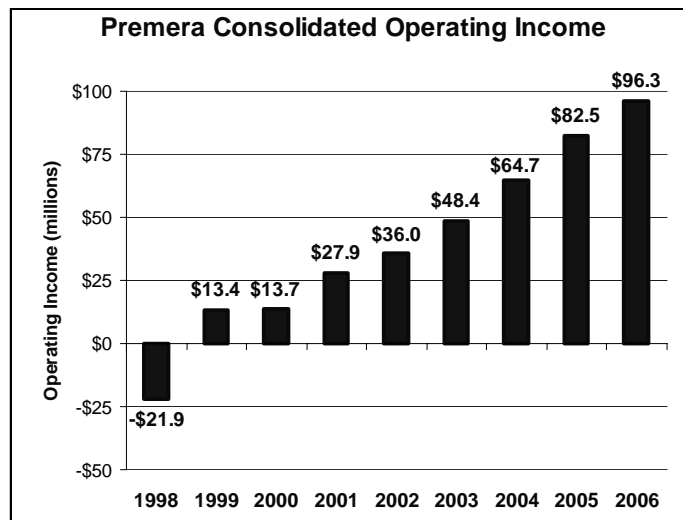
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## Expectations as a CFO

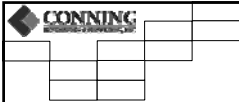
- No actuarial jargon – opening the Black Box
- Concise explanation of changes
- Clear explanations behind assumptions
- Bottom Line: Words are worth a thousand numbers!!

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## Results of Effective Communication



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## Communication of Financial Results: The User's Perspective

Society of Actuaries  
Health Spring Meeting, Seattle  
Session 17  
June 13, 2007, 1:30pm

Terence B. Martin, FSA, MAAA  
Conning Research & Consulting

### **“A Clean Bill of Health”**

*Barron's, 5/5/07*

“GO FIGURE. TWO WEEKS AGO, WellPoint, the nation's biggest health insurer in terms of members, announced a 16% jump in first-quarter earnings per share and boosted its full-year 2007 earnings guidance by a penny, to \$5.54 a share -- up more than 15% from the year-ago number. And yet the stock got toasted, falling some 4% to around \$79, before recovering to just \$81.43.”

## “A Clean Bill of Health”

Barron's, 5/5/07 (emphasis added)

- “... concern over a rise in the company's so-called benefit expense ratio”
- “Could it be, ... that WellPoint ... had allowed itself to be blindsided by an unanticipated surge in medical-cost inflation and set its premium levels too low?”
- “Private, for-profit health insurers like WellPoint are largely seen as greedy middlemen driving up administrative costs and often denying needed care in order enrich their shareholders at the expense of the country's citizenry.”

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## “A Clean Bill of Health”

Barron's, 5/5/07

- “Finally, the stock is cheap, selling at just 12.7 times the consensus 2008 earnings forecast of \$6.39 a share.”
- “WellPoint's sheer scale permits it to contain the growth in its administrative costs...”
- “Largely ignored was the fact that the company was able to maintain its profit margins by driving down its administrative-expense ratio from 15.9% of premium revenues in the year-ago quarter to 14.4% by increasing efficiencies in its back-office procedures. In other words, to the aggregator of insured lives go the spoils.”

**With coverage like this, who needs enemies?**

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## Rule 1: Know Your Audience

- Internal Users:
  - Board of Directors
  - Management
  - Department Heads
  - Employees
- Auditors
- Industry Analysts:
  - Rating Agencies
  - Regulators: SEC, Insurance Departments, etc.
  - Trade Press
- Wall Street: Equity and Credit Analysts
- General Press
- Stockholders, Politicians, Voters, General Public
- Your Competition

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## Internal Users

### Financial Results as “Data Dashboard”:

- Speedometer (How fast are we going?)
  - How much are we making each period?
  - “Run rate”
  - Benefit ratios, Cost ratios, Sales statistics
- Odometer (How far have we gone?)
  - What’s our accumulated surplus?
  - How much have we earned this year? (Trip Odometer)
  - RBC
  - Capital ratios
- Engine Diagnostics (Are all the systems working correctly?)
  - What’s selling and what’s not?
  - Is one product overheating while another is frozen?

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## Internal Users

### Financial Results as “Data Dashboard”:

- GPS (What’s around the corner?)
  - Are we ready for expected changes?
  - What about unexpected changes?
- Climate Controls (Is everyone comfortable?)
  - Is the driver comfortable? (Executive compensation, bonuses, stock options)
  - Are the passengers comfortable? (Merit increases, bonuses, employee benefits)

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## Internal Users

### Are looking for:

- Relevance
  - Why is \_\_\_\_ the answer?
  - What is impacted and how much?
  - What is the range of possible outcomes?
- Consistency
  - Between units, products, divisions, regions, etc.
  - Between time periods
- Granularity
  - Is there sufficient detail to give people what they need to manage?
  - Can you drill down if needed?
- Transparency
  - Methods and Assumptions communicated clearly, and at a level of detail appropriate for the user.

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## **Auditors**

### **Auditors are looking for:**

- Audit Trail
  - Ability to drill down
- Compliance with Accounting Standards
- Controls
  - Process has safeguards against errors and tampering
- Granularity
  - Is there sufficient detail to give people what they need to manage?
- Consistency
  - Method and assumptions unchanged unless there is a reason
- Explanation for differences
  - What changed and why?

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## **Auditors**

### **You want from your auditor:**

- A clean audit
- Learn from their experiences with other companies

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## Industry Analysts

- Rating Agencies
  - Much like Auditors, but:
  - More emphasis on solvency, claims paying ability
  - ERM
  - Looking to compare a company to their rating standards
- Regulators:
  - SEC: Stockholder and Investor focus
  - Insurance Department: Solvency and consumer protection focus
  - Looking for compliance with laws and regulations
- Trade Press
  - Looking for anything to sell subscriptions

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## Wall Street Equity and Credit Analysts

- Looking to compare one company to another.
- Looking to compare one sector to another.
- Ultimately, Wall Street wants the answer to two questions:
  - **Should I buy, hold, sell, (or even short!) the company's stock?**
  - **Should I buy, sell, or hold the company's bonds?**

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## Wall Street Equity and Credit Analysts

- Wall Street hates:
  - Uncertainty
  - Mysteries
  - Surprises
- In the eyes of Wall Street, Actuarial work:
  - Deals with **Uncertainty**,
  - Is **Mysterious**, and
  - Sometimes Gives **Surprising** Answers.
- 2006 Industry-Wide Statutory Balance Sheet (Orange Blank, \$M)

Claims Unpaid & Health Claims <b>Reserves</b>	\$28,741	←
Premiums Received in Advance	4,958	
General Expenses Due or Accrued	6,801	
Health Policy <b>Reserves</b>	6,646	←
<u>All Other Liabilities</u>	<u>21,785</u>	
Total Liabilities	<b>\$68,932</b>	
	<b>51.3%</b>	

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## Wall Street Equity and Credit Analysts

- How did the company do, absolute numbers and compared to estimates, in the following areas:
  - Revenue and Revenue growth
  - Membership trends
  - Earnings
  - Medical Trend
  - Pricing Discipline (Benefit ratios)
  - Cash Flow Generation
  - Earnings relative to Cash flow
  - Balance Sheet and Debt Trends
  - Share Repurchases
  - Liquidity and financial flexibility
  - Cash
  - Credit metrics (interest coverage, leverage, funds from operations to debt)

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## Wall Street Equity and Credit Analysts Red Flags

- Change in company strategy
  - Example: Company willing to tolerate lower credit ratings in order to finance share repurchases or to finance acquisitions.
- Maintaining disciplined pricing
- Success in integrating past acquisitions
- Success in ramping up new businesses:
  - New products such as Medicare Part D
  - Expansions into new geographic areas

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## General Press, Politicians, Voters, General Public, and Your Competition

- What do they want? Everything listed so far...and then some.
- “You can’t always get what you want”
- You are always in control what you say, and what you don’t say.
- Whenever possible, prepare ahead
  - Know what they want, and why they want it
  - Know what you’re going to say, and how you’re going to say it.
  - Anticipate possible questions
  - Plan your “escape route” (examples: Direct them to website, annual statement, regulatory filings, etc.)
  - “I’m not sure. Let me get back to you.” ...but don’t forget to do it!

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## **Above all, and in all situations...**

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